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FINANCIAL SERVICES FOR SMALL AND MICRO ENTERPRISES: A NEED FOR POLICY CHANGES AND INNOVATION

by

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ABSTRACT

The current interest in developing small and micro enterprise financing projects is reminiscent of earlier attempts to finance special small farmer credit projects. This paper reviews the generally negative experience of those efforts and identifies areas of policy change and innovation that emerges from that review which can guide the design of micro enterprise projects. The experience of the Grameen Bank in Bangladesh is also reviewed as one of the most interesting innovations in providing small loans to the rural poor.

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INTRODUCTION

The great concern that exists today for providing financial services to small and micro enterprises is reminiscent of the flurry of activity in the 1960s and early 1970s to finance small farmer credit programs. The approaches, the rationale, the political concerns, the proposed earmarking and targeting of funds are similar to that earlier period. The generally negative evaluation of that small farmer experience, especially in terms of the failure to build strong, viable, self-sustaining financial institutions to serve small farmers, suggests a need for caution in the current enthusiasm for developing special programs to finance nonfarm enterprises. It is important to analyze the small farm experience with a view towards identifying those factors that may determine success or failure for small and micro enterprise financing projects.

There are two purposes for this article. The first is to briefly review the small farmer experience, and the second is to identify areas of policy change and innovation that emerge from that review which can guide the design of project and programs for small and micro enterprises. Since the Grameen Bank in Bangladesh is one of the most interesting innovations in recent times (and which gets a large, perhaps excessive, amount of publicity), an attempt is made to also identify lessons learned from its experience.

No distinction is made in this paper between small and micro enterprises. Although there are differences which may be important for some purposes, what is of concern from the financial perspective is that the clients are small operators, mostly individual proprietors, operating out of their homes and/or workshops, producing and/or marketing products using fairly simple technology, with no or only simple business accounts, self-financing most of their investment and working capital, employing few workers, and facing considerable risk in the supply and price of inputs, and in the price of outputs. Most have had no experience with formal financial intermediaries, or at most they use only checking and savings services. Most are not very attractive customers to the commercial banking sector compared to larger, more sophisticated clients who maintain more extensive written accounts and have established banking and credit relationships. Many of these enterprises are located in rural areas or small towns where financial services are not readily available for either farm or nonfarm clients. Many are linked through backward or forward linkages to the agricultural sector, so their success depends greatly on agricultural performance.

THE FINANCIAL SERVICES PROBLEM

The financial "problem" with respect to small nonfarm enterprises, as perceived by policy makers, appears to be similar to past perceptions of the small farmer credit problem. The enterprises are perceived as being small, backward, unproductive, and a drag on economic growth for several reasons, but an inadequate supply of low interest, long term credit is identified as a major problem that policymakers think they can do something about in the short run. Short term working capital may also be perceived as a problem but it is expected that entrepreneurs can more easily obtain credit for such capital. Existing financial intermediaries are perceived as being conservative, risk averse and uninnovative with respect to small enterprise lending, and prefer instead to concentrate their loan portfolio on larger enterprises or financing large scale commerce and trade. The "need" of the small enterprises is identified as loans and no consideration is given to the value of banks providing a supply of safe, dependable deposit and savings services. If these enterprises borrow, it is usually short term and emergency loans from informal sources that are perceived as charging usurious interest rates.

THE RESPONSE OF POLICY MAKERS

Faced with this perception of the problem, policy makers have introduced several measures to finance small farmers, and many of these are now being introduced in small and micro enterprise projects.

1. Increase the supply of funds available for lending to the priority sector (small farmers or enterprises) through:
    a. portfolio quotas or targets for existing lenders,
    b. the creation of specialized financial institutions to work only with the priority sector(s),

c. lending by non-financial institutions (ministries, departments, institutes), and

d. rediscount programs through the central bank, often funded by donors.

2. Reduce the interest rate of loans to the priority sector through:

a. interest rate ceilings which set the lowest rates for the smallest/poorest borrowers,

b. low interest rates charged on refinance funds provided by the Central Bank,

c. encouragement to banks to cross-subsidize by charging higher rates to non-priority borrowers in compensation for low rates to priority borrowers,

d. mandatory placement of private and/or public deposits in specialized lending institutions, and

e. direct government interest subsidies to lenders.

3. Reduce lending risks and costs through:

a. targeting loans for purposes assumed to be profitable and/or priority,

b. crop and loan guarantees,

c. creation of joint liability through lending to groups of borrowers,

d. technical assistance to lenders to help improve institutional efficiency, and

e. establishing lines-of-credit for preferred borrowers.

4. Nationalization of banks that fail to meet social objectives.

PROBLEMS OF PROJECTS AND PROGRAMS

In some cases the measures taken by policy makers have succeeded in temporarily expanding lending to the priority sector. Some institutions have gained experience in lending to a new clientele and some have introduced innovations to more effectively serve customers. The failures are more numerous, however. They have been extensively documented elsewhere and will only be summarized here.[1]

1. Quotas and targets have been ignored or evaded by means such as creative loan documentation and multiple small loans to large borrowers.
2. Lenders accept the alternative to lending such as buying low interest government securities.
3. Interest rate controls result in implicit price rationing of loans which leads to high borrower transaction costs and a concentration of loans among wealthier borrowers.
4. A diversion of cheap loans from intended purposes into higher return activities, and the substitution of borrowed for own capital.
5. Political intervention to direct "cheap" loans to particular clients and to protect delinquent borrowers.
6. High lender transaction costs due to heavy reporting requirements.
7. High loan delinquency and default.

8. Weakening of institutions because of high lending costs, low loan recovery and a failure to mobilize deposits.

9. Institutions are unreliable from the borrower perspective because their liquidity and survival depend on the whims of government or donor funding.

In short, viable, self-sustaining institutions have not been developed, a few fortunate borrowers may have enjoyed a one-shot increase in liquidity, close lender-borrower relations have not been built, and the difficult problems faced by priority borrowers have not been reduced so that they can become more attractive customers to financial institutions. If innovations have occurred they have often been designed to avoid rather than implement the intent of the decisionmakers.[2] The lenders have not developed the interest nor expertise needed to continue to effectively serve the priority sector(s).

THE GRAMEEN BANK EXPERIENCE

The Grameen Bank in Bangladesh is one of the most publicized programs today designed to meet the financial needs of low income people. Its relative success in the midst of so many failures makes it worthy of special comment. The comments presented are derived from observing its evolution during the past ten years and reviewing in-depth studies of its operations.[3] Although it contains many innovative features, it must be recognized that there are similar programs in Bangladesh (especially the Swanirvor program) and elsewhere, but they don't have the same recognized success as does the Grameen Bank.[4]

The activities which eventually evolved into the present day Grameen Bank began with the efforts of the founder, Professor Muhammed Yunus of the Department of Economics, Chittagong University, to obtain credit for the landless without collateral in an area near his university[5]. That initiative evolved from a program to assist borrowers to obtain credit from cooperating banks to an independent bank, partly owned by its low income clients.

The essential characteristics of the Grameen Bank are the following:

1. A bank branch with a Field Manager (FM) and several bank workers (BW) covers an area including 15 to 22 villages.
2. Persons with families owning less than 0.5 acres of land or assets valued at less than one acre of land are eligible for a loan.
3. The FMs and BWs travel among the villages organizing groups of five members who are like-minded and have similar social-economic backgrounds. Each group elects its own chairman and secretary and holds weekly meetings. Males and females belong to different groups.
4. After a month-long training period, the two most needy members are invited to submit loan proposals. The proposals are discussed in group meetings, reviewed by the BW, and eventually submitted for approval by the FM and zonal office.

5. Loans are collateral-free and repayments are usually collected weekly at the rate of 2 percent of the principal. If the first two borrowers use the proceeds as requested, make payments when due, and observe rules and regulations, the next two members will be invited to apply. If not, the remaining members automatically are disqualified. If one of the five willfully defaults, no new loans are made until all arrears are cleared.
6. Group members save one taka[6] per week plus five percent of the loan amount which is set aside at the time of disbursement. This Group Fund can be borrowed from in time of need at terms set by the group. An Emergency Fund is also created with payments of 25 percent of the interest due after the loan is fully repaid. It can be used to repay the loan of a member who is unable to repay due to accident or other unforeseen reasons.
7. The interest rate on loans is 16 percent, the going rate for rural areas, but the effective interest rate for the borrower is well over 20 percent because of the forced savings in the Group Fund and the Emergency Fund.
8. A male BW serves about 250 members while a female BW serves 150 members. They visit the groups weekly to collect savings and loan payments, and disburse loans. As of April 1986, about two-thirds of the members were women and they received about 55 percent of the loans disbursed.

9. The Grameen Bank does not target loans. It basically finances non-crop agricultural and non-farm activities. Loans have been extended for over three hundred different activities. Initially, trading and shopkeeping represented the largest sector financed. As the share of female members rose, livestock and fishing sector loans expanded. Beginning in 1982, collective or joint enterprise loans were extended and these represented five percent of the amount of loans disbursed in 1985.
10. As of April 1986, the Grameen Bank had grown to over 200 branches, covering more than 4,000 villages with almost 200,000 members and over 1.1 billion taka in total loans disbursed. At that same date, over 99 percent of the loans had been recovered within one year of disbursement and over 99 percent within two years of disbursement.

Two issues are often debated about the Grameen Bank. One concerns the importance of Professor Yunus in explaining its success and the ability of the organization to maintain high performance in its rapid expansion. The other concerns the extent to which it grants subsidized credit. On this second issue, there is some information. First, in one sense of the term, it does not engage in subsidized lending because it charges the same interest rate as do the nationalized commercial banks for rural loans, plus the implicit interest involved in the forced savings funds. Thus, the effective annual interest rate to the borrower is well over 20 percent. On the other hand, in

1985 its loan funds cost only 5.8 percent. An important reason was the relatively low 2.9 percent cost of funds from foreign institutions (largely IFAD), which represented almost 40 percent of total loan funds, compared to about 8 percent charged for funds received from the Central Bank. If it would have paid the 8.5 percent rate charged by the Central Bank to other lenders, its' cost of funds would have represented 22.9 percent of loans and deposits. On the revenue side, it has maintained about half of its funds in fixed and term deposits which represent low risk and operating costs, but earned an average rate of 12.5 percent interest in 1985. Thus the approximate 7 percent spread on financial operations helped compensate for the cost of lending operations. Whether or not this implicit subsidy is justified to cover start-up costs is an issue beyond the scope of this paper. The magnitude of the subsidy, however, implies it is too great to be sustained if the program was to be extended to the millions of rural poor in the country.

NEED FOR POLICY CHANGES AND INNOVATION

The negative experiences of many farm credit projects as well as many small scale and micro enterprise projects suggest a need for major changes in the way that finance is viewed and handled in development projects. The fairly positive results enjoyed by the Grameen Bank, as well as some other projects, suggest areas for policy changes and future innovation:

1. Interest rate policy. Interest rates need to be high enough to cover lender costs, default risks and inflation. Only in this way can lending institutions/programs become viable and self-sufficient. Subsidies imply continual handouts from government and donors, on the one hand, going to a small group of privileged beneficiaries, on the other hand. Interest rate policies must also be flexible enough to adjust to changes in cost of funds and inflation.
2. Targeting of loan funds. Loans are most valuable when they meet borrower needs; they are least valuable when borrowers are forced to use them for specific purposes. Borrowers are more likely to repay when they perceive the opportunity of getting a new loan.[7] Therefore, a whole household or firm approach, rather than an enterprise approach, is necessary for developing client-borrower relationships. Borrowers need the opportunity to borrow for their perceived needs. Because of fungibility of funds, loans will not flow into targeted purposes anyway if they are not perceived as profitable or useful.
3. Group lending. Lending to groups offers possibilities to reduce lender costs and improve loan recovery. In practice, however, attempts at group lending have often failed to discover the appropriate group dynamics that will actually produce the expected benefits. The solidarity group approach in the FEDECCREDITO project in El Salvador, the groups formed within the CIDES cooperative in Columbia[8], the

solidarity group component of the PRODEME project in the Dominican Republic[9], and the Grameen Bank groups appear to be most successful. Successful groups appear to be small, homogeneous, and self-select their members.

4. Loan payback. Loan repayment must be based on frequent loan installments, frequently weekly or daily. Establishing the habit of paying installments on a timely basis and even requiring repayment faster than easily generated by the cash flow of the project funded is important in establishing responsible borrowing.

5. Using financial institutions. Providing credit through non-bank rather than banking institutions usually increases opportunities for political patronage and results in sloppy lending practices, poor bookkeeping and ineffective or nonexistent loan recovery activities. Assisting entrepreneurs to obtain credit from regular banking sources helps them to become acquainted with bank procedures, gives them access to deposit and other banking sources, and helps familiarize the banks with the operations of potential new customers.

6. Developing close bank-client relations. The objective of a small enterprise project should be to assist entrepreneurs to become long-term customers of a financial institution(s). This should also be the objective of the financial institution. Therefore, both entrepreneur and banker should work towards developing closer bank-client relations which can lead to simplified banking procedures and lower transaction

costs for both. Inventory norms may provide some guidelines in setting lending limits until information about individual customers can be obtained (Liedholm).

7. Savings mobilization. Financial institutions should strive to become financially independent by mobilizing a large share of their loanable funds. This will make them more immune from government pressures, improve discipline in financial operations, improve loan recovery and provide important deposit and savings services to customers.[10] Examples of projects where borrowers have been forced to make deposits include Grameen Bank, BKK in Indonesia, and the ADEMI project in the Dominican Republic. Voluntary savings deposits, however, would seem to be necessary if institutions are to mobilize sufficient deposits to achieve self-sufficiency. Interestingly, the Grameen Bank has begun to accept deposits from persons who do not qualify as members of its target group.

8. Increase the spread of banking outlets. An expansion in banking outlets is the single most important factor affecting bank deposits[11]. It also contributes to rapid credit delivery, increased credit turnover, and lower administration costs due to economies of scale. Furthermore, by reducing costs, decentralizing branches, and improving credit evaluation, financial institutions can more easily afford to service small loans and deposit accounts needed by low income customers. Since formal bank branches are

expensive to operate, some innovations are being explored, such as mobile branches which travel to towns and villages on market days, and partial service branches.

9. Market linkages and the informal sector. Greater use needs to be made of nonbank institutions as a source of credit services. Subcontracting with larger firms can provide both credit and a secure market for output (Mead). Informal financial organizations such as ROSCAs are widely found in developing countries and may be linked to formal financial groups. Efforts are underway in Asia to develop more links between self-help groups and financial institutions to provide a place for such groups to bank their savings as well as increase their access to loans (Quinones). Credit unions represent an organizational form between small informal groups and formal banks that are being effectively formed in many countries. All these alternatives represent examples of ways to transfer high transaction costs from financial institutions that don't want to or can't bear them to institutions and/or customers that are willing to bear them.

10. Risk reduction. Loan guarantees are frequently thought of as the best way to reduce risks to lenders. They frequently don't work well in practice, however, and often times simply represent subsidies hidden under another name. More effective ways to reduce risks are likely to develop if a) lenders are permitted to diversify their loans in a par-

ticular location rather than target them on a particular enterprise or sector, and if b) they are encouraged to distribute their risk across locations and/or markets through branching, secondary markets for loans, and liquidity funds.

CONCLUSIONS

Small farmer credit programs have generally been unsuccessful in meeting the needs of creating viable, self-sufficient financial institutions. In some cases they have simply provided a one-shot increase in liquidity for the borrowers lucky enough to get the loans. Far too frequently, the distribution of loans has been concentrated among richer farmers, transaction costs have been high for both lender and borrower, and loan recovery rates are low. Many of these same problems exist for projects targeting small nonfarm enterprises. The exceptional cases, including the Grameen Bank, are worthy of analysis because of the insights that they provide about the innovations that may improve project performance.

Creating a more flexible set of rules and regulations under which credit projects operate is a necessary condition for creating long term, viable programs. It is now fairly well accepted that more flexibility in interest rate policy is essential. Subsidized rates obviously provide benefits to borrowers, but the cost may be high in terms of the way they undermine the financial institutions. A wide range of other policy changes and innovations may also be usefully undertaken.

A key issue must be addressed by all policymakers, donors and NGOs interested in stimulating small enterprises. This concerns the economic environment faced by entrepreneurs and the extent to which this environment must be altered before they will become attractive clients to financial institutions. Subsidized credit cannot compensate for high input prices, low product prices, unstable input supplies, poor information and transportation systems, and complicated rules and regulations that favor large enterprises. Tinkering with credit policies and programs will not make unprofitable enterprises profitable.

FOOTNOTES

1. Examples include Adams et al., Ashe, Chew, Farbman, and Lieberson.

2. An explanation of this process is presented by Kane in "The Political Economy of Subsidizing Agricultural Credit in Developing Countries" in Adams et al.

3. See the two volumes by Hossain, and Nurazzaman.

4. Some of the essential features of the Grameen Bank, such as group lending, compulsory savings, and the use of high interest rates, can also be found in some micro enterprise financing projects in other countries. For example, group lending is practiced in India, the Dominican Republic and Kenya. The insistence of savings is found in the PRODEME project in the Dominican Republic and the BKK project in Indonesia. BKK also uses a market-oriented interest rate.

5. The initial program is described in Yunus.

6. The exchange rate has been approximately 25 to 30 taka = $1.00.

7. See further discussions by Kilby and D'Zmura, and Ashe on this point.

8. Discussed by Farbman.

9. Discussed by Ashe.

10. A more complete discussion of the importance of deposit mobilization is found in Meyer.

11. A test of factors affecting bank deposits in South Asia is found in Srinivasan and Meyer.

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